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January 2004

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The Economy in Perspective

Dude, Where's My Economy?... Objectively speaking, the U.S. economy seems to stand on solid ground. Production and spending accelerated throughout 2003; by year's end, employment had begun to expand, albeit moderately. Moreover, business and consumer sentiment strengthened throughout the year, and the stock market—the ultimate financial arbiter of expectations—rebounded impressively. Mainstream economic forecasts for 2004 anticipate continued solid growth in economic activity, with joblessness receding and inflation remaining dormant.

Yet the nation still has economic issues to contend with, and public opinion is divided regarding the best course of action. One question that commands attention nationally, but particularly in the Midwest, is the fate of the country's manufacturing sector. Even manufacturing's most ardent supporters acknowledge that, for many decades, its contributions to U.S. gross domestic product and employment have been shrinking as a proportion of the economy as a whole.

Such a trend by no means implies that manufacturing businesses or employment have become, or are becoming, unimportant to the country. In fact, improved productivity growth in manufacturing industries is a prominent explanation for manufacturing's smaller share of the growing national work force. Over time, strong productivity growth has lowered the prices of many manufactured goods compared to services. And the manufacturing industries can hardly be blamed for another significant factor in the service sector's expansion—that consumer preferences for services increase disproportionately as household wealth and income increase. Think medical care.

Innovation, productivity, and shifting consumer preferences go a long way toward explaining which industries expand and which contract. Within the context of these longer-term forces, international trade certainly provides additional challenges, as well as opportunities, for domestic manufactures. Some of today's business and civic leaders are fixated on the challenges of competing with firms that operate in developing countries, despite two facts. First, longer-term fundamentals historically have influenced the overall size of the manufacturing sector more strongly than foreign competition has.

Second, as developing nations mature, they provide expanding markets for U.S.-made goods in which we have a comparative advantage. These desirable items might not be the same ones that originally built up Midwestern manufacturing towns and, in the future, they might not be made in those places either.

As our nation matured, some towns that once prospered because of their location or natural resources were overtaken by innovation, migration, and new methods of doing business. Then, a century ago, the United States entered a stage in which its economic power was expanded tremendously by, but also concentrated in, the hands of monopoly trusts. Abuses of power and corruption doubtless augmented the strength of these trusts, but innovation and productivity were the real forces behind them. It simply made business sense to standardize products, produce in large batches, and streamline the distribution and retailing channels.

We should recall that this era of industrialization brought not only general prosperity but also a reconsideration of the norms of competition and social justice. Innovation and trade can disadvantage some, but they have the potential to create far more winners than losers. Our response to the challenges posed by global trade should not be to resist change but to establish and abide by rules of fairness among the countries that are emerging on the world stage. If we are committed to a world in which nations trade freely with one another, then we must inevitably adjust to the consequences of that commitment.

Fortunately, despite the many trials that lie ahead, the American public seems optimistic about the economy. For example, according to information collected by the Roper Center for Public Opinion Research, the overwhelming majority of respondents to several 2003 surveys expected that the economy would be in better shape after another year and they reported that they were very happy overall in their lives. It is true that most respondents to a December 2003 survey described the nation's economy as "not so good" or "poor," but then again, respondents answered this question the same way in 1993.

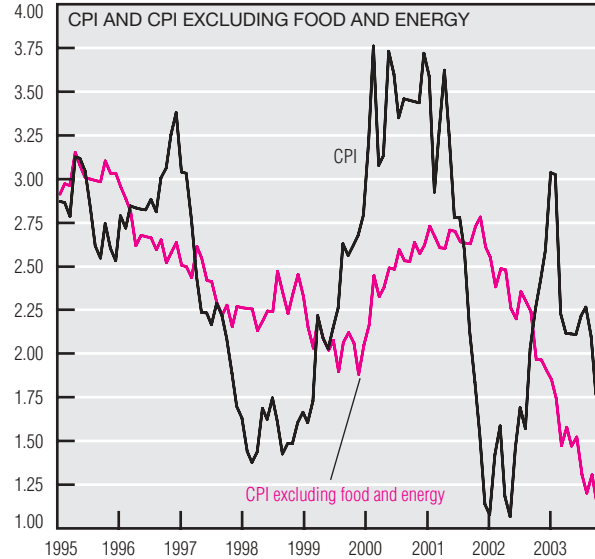
Hey, people may feel down, but they know they're not out. Dude, that's my economy!

Inflation and Prices

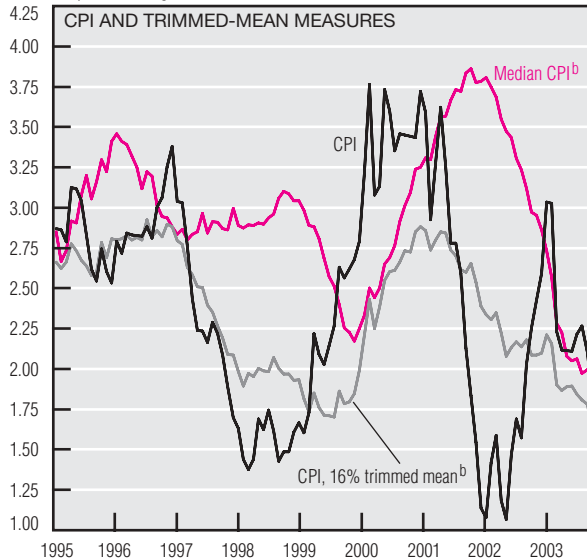
November Price Statistics

	Percent change, last:				2002 avg.
	1 mo. ^a	3 mo. ^a	12 mo.	5 yr. ^a	
Consumer prices					
All items	-2.6	0.2	1.8	2.4	2.4
Less food and energy	-0.6	0.8	1.1	2.1	2.0
Median ^b	1.6	2.2	2.0	2.8	3.0
Producer prices					
Finished goods	-3.3	3.1	3.4	2.0	1.2
Less food and energy	-0.8	1.9	0.5	0.9	-0.5

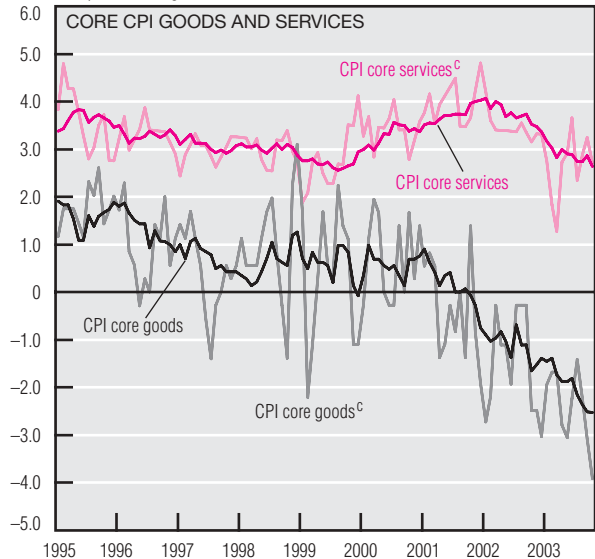
12-month percent change



12-month percent change



12-month percent change



a. Annualized.

b. Calculated by the Federal Reserve Bank of Cleveland.

c. Three months annualized.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Federal Reserve Bank of Cleveland.

The November inflation data show a continuing, generally broad-based pattern of disinflation.

The Consumer Price Index (CPI) declined an annualized 2.6% in November after holding unchanged in October. The decline was partly the result of falling energy prices, which continued their descent by slipping another 3.0% after declining 3.9% in October.

The core CPI, a closely watched measure of inflation that eliminates

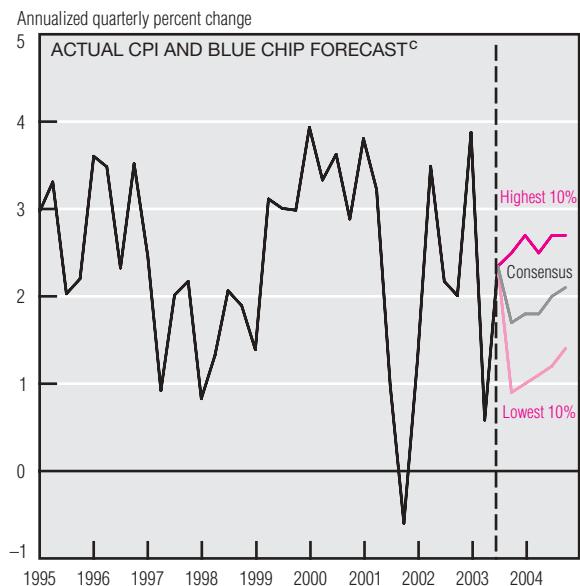
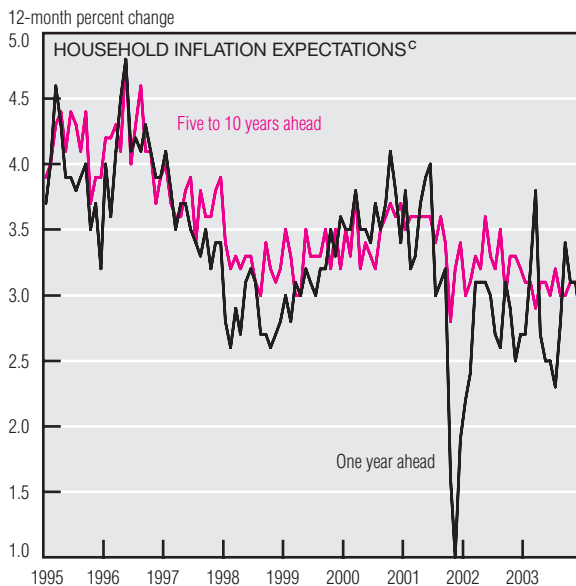
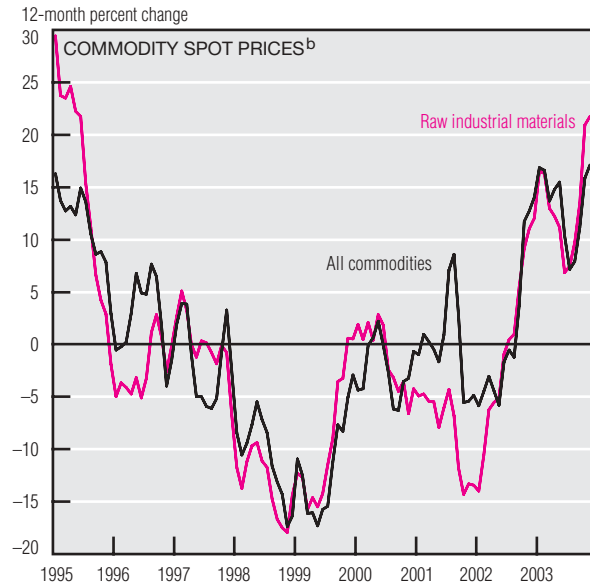
the CPI's volatile food and energy components, fell at a 0.6% annualized rate in November, its first decline in more than 20 years. The median CPI and the 16% trimmed-mean CPI, alternative inflation measures designed to exclude the most extreme price changes, rose at a 1.6% annualized rate and declined at a 0.9% annualized rate, respectively. Year-over-year comparisons within the core and alternative CPI inflation measures continued to trend downward.

Core consumer goods prices, which account for 23% of the total CPI, have shown persistent declines over the past two years, and that deflation appears to be accelerating. Moreover, the gap between core services prices and core goods prices continues to widen: Whereas the price level of core services is still increasing at a year-over-year rate of roughly 3.0%, the price level of core goods is deflating at a year-over-year rate of approximately 2.5%. Prices of

(continued on next page)

Inflation and Prices (cont.)

	Share	Percent change, last		
		3 mo. ^a	12 mo.	5 yr. ^a
New vehicles	4.8	-2.6	-2.1	-0.9
Household furnishings and operations	4.6	-1.9	-2.3	-0.3
Communication	2.8	-3.6	-3.9	-2.1
Used cars and trucks	1.8	-28.9	-11.2	-3.0
Women's and girls' apparel	1.7	-0.7	-2.0	-1.9



a. Annualized.

b. As measured by the Knight-Ridder Commodity Research Bureau's Composite and Raw Industrials Spot Commodity Price Indexes.

c. Mean expected change in consumer prices as measured by the University of Michigan's *Survey of Consumers*.

d. Blue Chip panel of economists.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Commodity Research Bureau; University of Michigan; and *Blue Chip Economic Indicators*, December 10, 2003.

new vehicles, used cars and trucks, household furnishings, and apparel all show persistent declines.

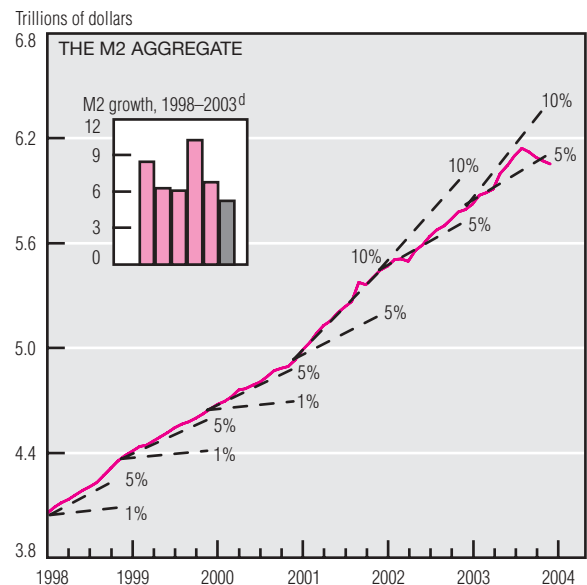
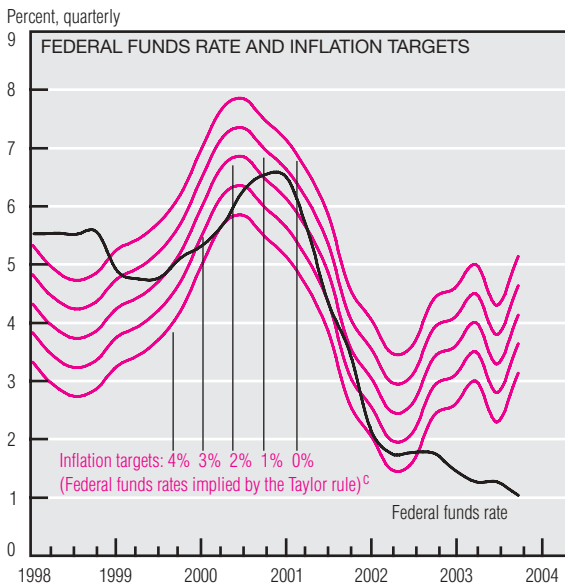
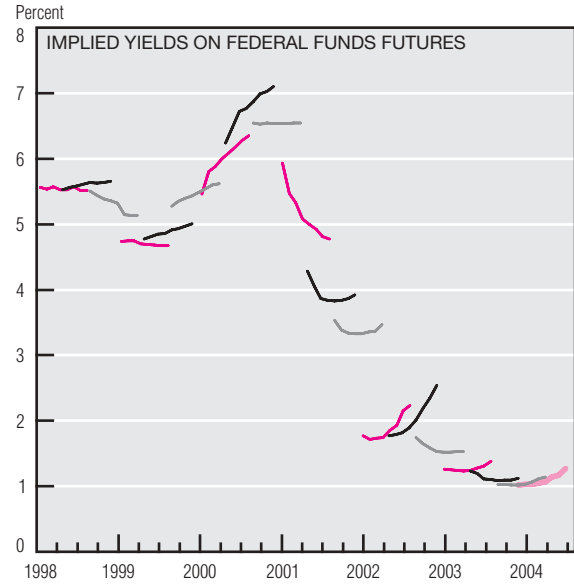
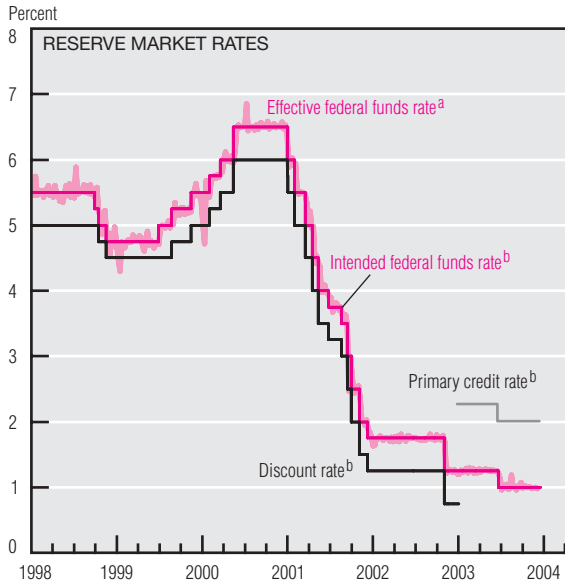
Interestingly, accelerated deflation in core goods prices persists as the year-over-year rate of change in commodity prices continues to rise. Some argue that commodity price movements are a leading indicator of inflation because they are a significant input cost for producers; however, evidence of this leading relationship

is mixed. After falling for more than five years, the recent significant increase in commodity prices since mid-2002 has not yet produced a rise in core goods prices.

Meanwhile, the University of Michigan's *Survey of Consumers* reveals that household inflation expectations for the next year are falling as well. December survey data suggest that on average, households expect a 2.8% increase in prices

in the next year and a 3.1% increase in the next five. The Blue Chip panel of economists still expects CPI-measured inflation to grow at an annualized rate of about 2% over the next five quarters, a forecast similar to the current CPI growth trend. The inflation pessimists predict a rate of 2.8% by 2004, and the inflation optimists now expect a CPI increase of about 1.2% by then, a reduction from last month's 1.4% estimate.

Monetary Policy



a. Weekly average of daily figures.

b. Daily observations.

c. The formula for the implied funds rate is taken from Federal Reserve Bank of St. Louis, *Monetary Trends*, January 2002, which is adapted from John B. Taylor, "Discretion versus Policy Rules in Practice," *Carnegie-Rochester Conference Series on Public Policy*, vol. 39 (1993), pp. 195-214.

d. Growth rates are calculated on a fourth-quarter over fourth-quarter basis. Data are seasonally adjusted.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Congressional Budget Office; Board of Governors of the Federal Reserve System, "Selected Interest Rates," H.15, and "Money Stock Measures," H.6, *Federal Reserve Statistical Releases*; and Bloomberg Financial Information services.

At its December 9 meeting, the Federal Open Market Committee (FOMC) decided to keep its target federal funds rate at 1%. The press release noted, however, that the FOMC now finds a reduced probability of "an unwelcome fall in inflation." In line with the October 28 statement, policy accommodation is expected to continue for "a considerable period."

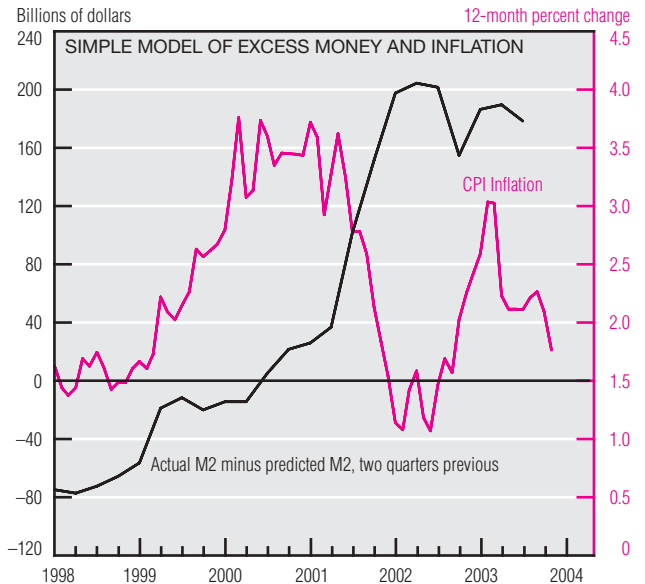
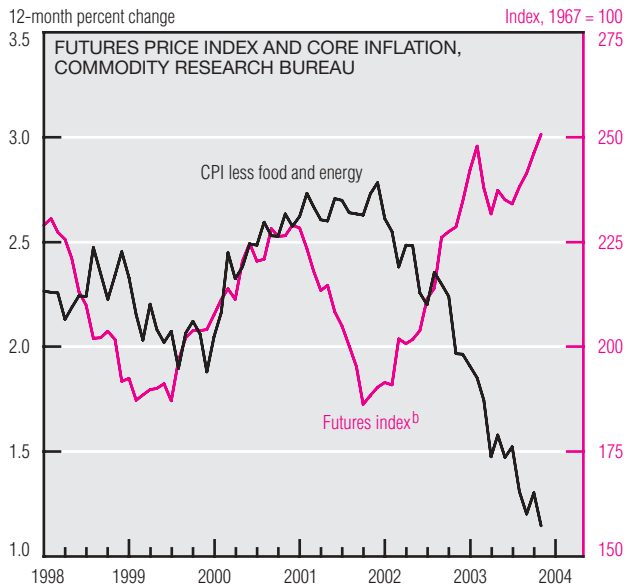
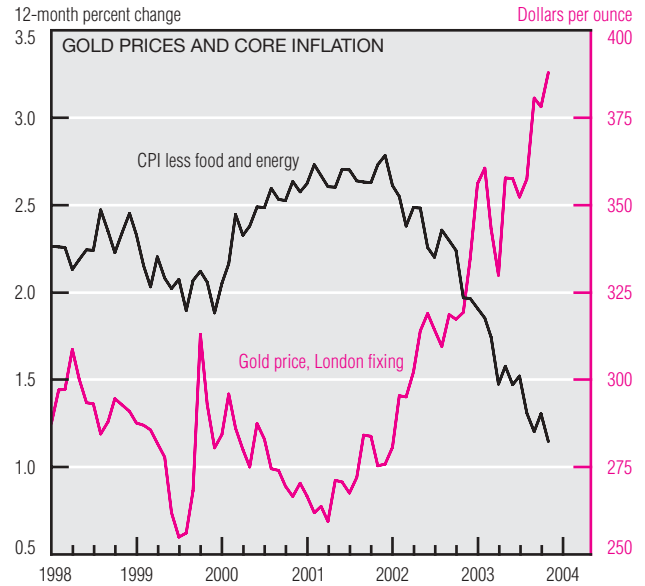
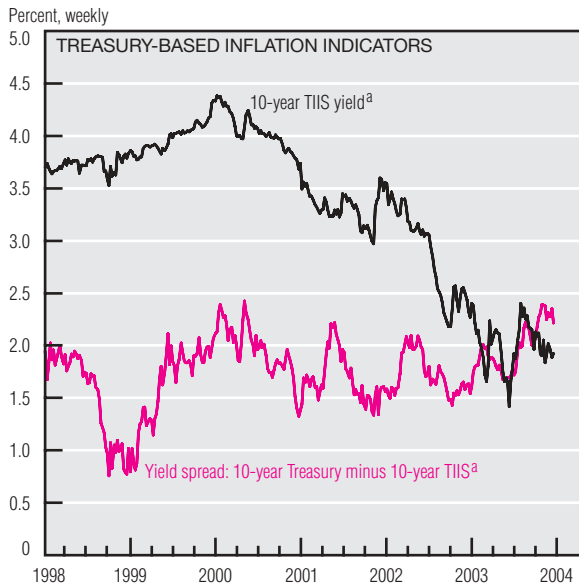
Market expectations may have reacted more strongly to the minutes of the October meeting, which some

market observers took to indicate that the target rate would remain at its current level longer than they had previously expected. They were perhaps reacting to the minutes' statement that FOMC members felt current trends "were likely to hold inflation to very low levels over the next year or two."

So it is not surprising that the implied yields of federal funds futures show only small increases through 2004, although a glance at the market's predictions since 2000

shows it is far from infallible. The December decision also keeps rates well below a popular benchmark provided by the Taylor rule, which posits that the FOMC chooses the target rate as a balanced response to weakness and inflation. The form of the Taylor rule depends on the weights given to inflation and output and to the assumed inflation target. However, the low rates have not led to a surge in the money supply, which has grown less than 5% in 2003.

Money and Financial Markets



a. Treasury inflation-indexed securities.
b. All commodities.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System, "Selected Interest Rates," H.15, and "Money Stock Measures," H.6, *Federal Reserve Statistical Releases*; Bloomberg Financial Information Services; Commodity Research Bureau; and *Wall Street Journal*.

Much of the current discussion about monetary policy focuses on the prospects for inflation—what do financial market indicators say? Expectations derived from the yield spread between the Treasury's nominal and inflation-indexed securities show a pronounced upward trend in the latter half of 2003. These expectations have neared their six-year high, although inflation during this period has been low by historical standards.

Some close observers of the gold and commodities markets have become concerned about the risk

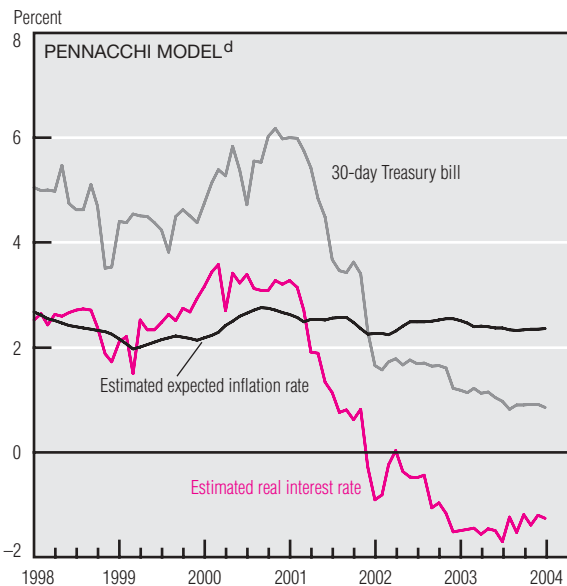
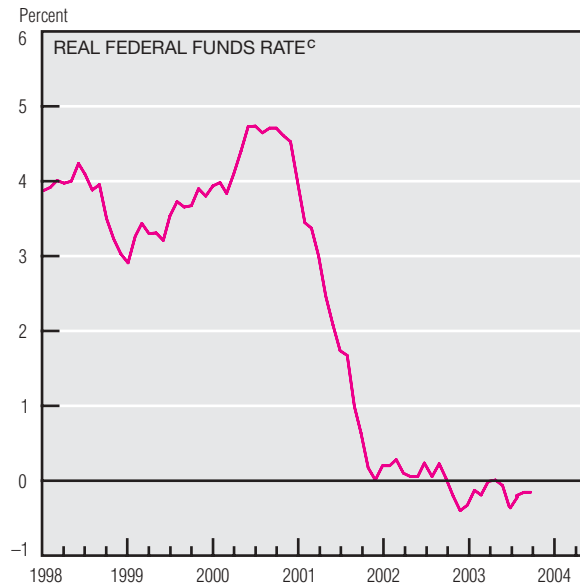
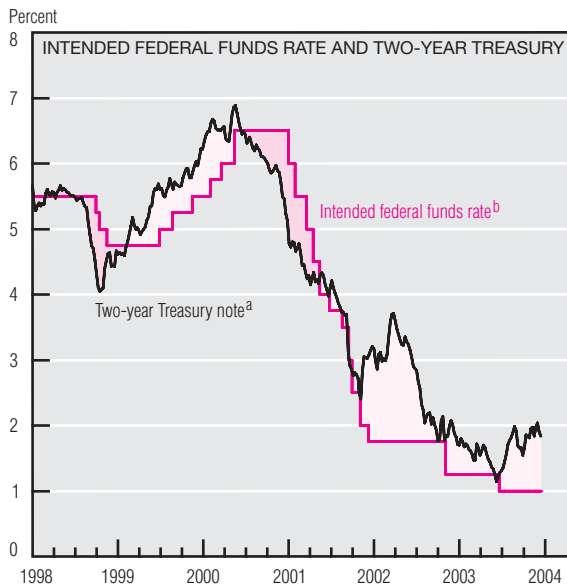
of higher inflation. Gold prices have posted a dramatic increase of \$60 (18%) since March 2003. The commodities futures price also has increased recently, although it remains near the level at which it started the year. Prices for both gold and commodities have increased substantially since 2001. Unfortunately for fans of these two indexes, however, neither shows a strong correlation with inflation. What gold prices show, if anything, is a negative correlation with core CPI inflation. Commodity prices sometimes seem

to anticipate future inflation but they have not done so for the past three years.

A classic definition of inflation is "too much money chasing too few goods." By this definition, comparing the money supply with money demand on the basis of income and interest rates may indicate incipient inflation. While the measure of excess money has trended high in 2003, its record over the past five years suggests that this indicator should be used with caution.

(continued on next page)

Money and Financial Markets (cont.)



a. All yields are from constant-maturity series.

b. Daily observations.

c. Effective federal funds rate deflated by the PCE chain price index (less food and energy and excluding insurance adjustments).

d. The estimated expected inflation rate and the estimated real interest rate are calculated using the Pennacchi model of inflation estimation and the median forecast for the GDP implicit price deflator from the *Survey of Professional Forecasters*. Monthly data.

e. The Berk rate is calculated as the 30-year GNMA yield plus the 10-year Treasury inflation-indexed securities yield minus the 10-year Treasury yield.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

Another gauge of policy is the relation between the intended federal funds rate and other market rates. A comparison with the two-year Treasury note is particularly apt because that yield is long enough to avoid being a mere reflection of guesses about the Fed's move, yet short enough to avoid speculation about long-run trends. Except for a few brief episodes, the target fed funds rate has been below the two-year yield since late 2001. Since June 2003, the spread

has increased from 11 basis points (bp) to 84 bp, confirming the continued ease of policy.

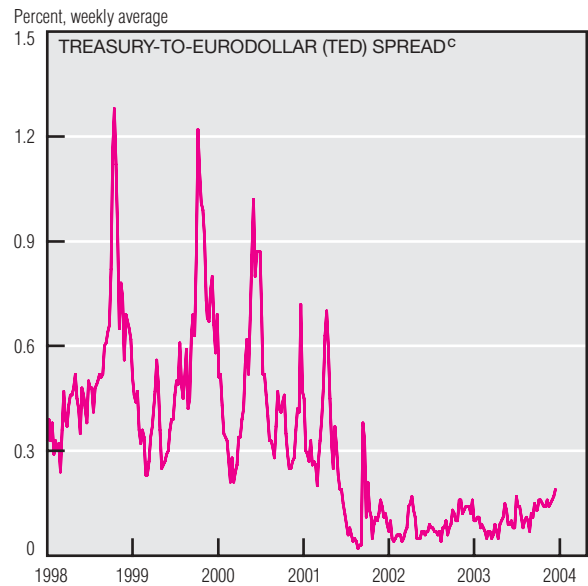
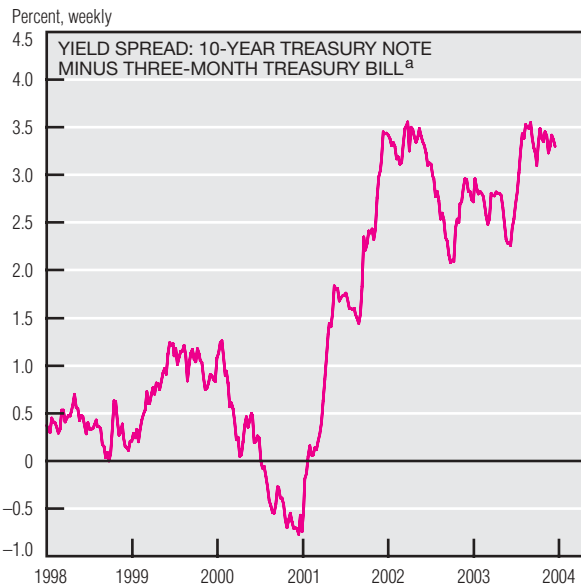
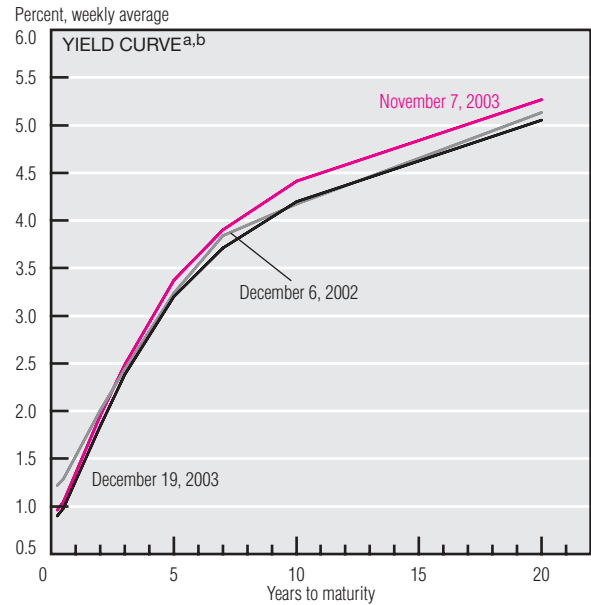
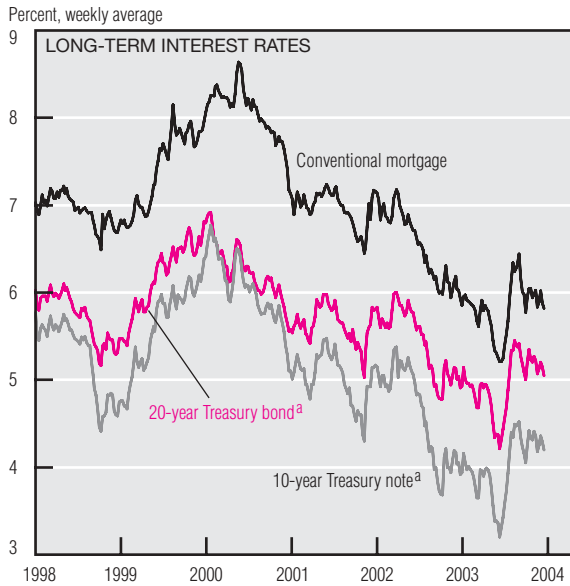
One more possible comparison is between interest rates and inflation. Inflation means borrowers pay back dollars that are worth less than the dollars they borrowed, so yields should be adjusted for inflation. This makes the real fed funds rate (adjusted for inflation by subtracting the current growth in CPI from the yield) even lower than its minimum nominal value

of 1%; in fact, it has been negative for most of the year. One may also estimate real rates using inflation expectations, and the Pennacchi approach estimates 30-day real rates. These have remained steadfastly and substantially negative throughout 2003.

Longer-term real rates, though low, have stayed positive and become more variable. An important real rate, which is thought to have a particular influence on investment spending,

(continued on next page)

Money and Financial Markets (cont.)



a. All yields are from constant-maturity series.

b. Average for the week ending on the date shown.

c. Yield spread: three-month Eurodollar minus three-month constant-maturity Treasury bill.

SOURCES: Board of Governors of the Federal Reserve System, "Selected Interest Rates," *Federal Reserve Statistical Releases*, H.15; and Bloomberg Financial Information Services.

takes a common callable bond, the 30-year GNMA, and subtracts, as an inflation estimate, the yield difference between a 10-year Treasury bond and a 10-year Treasury inflation-indexed security. This option-adjusted rate (dubbed the "Berk rate" after the economist who developed the idea) has decreased lately, falling about 23 bp since mid-October.

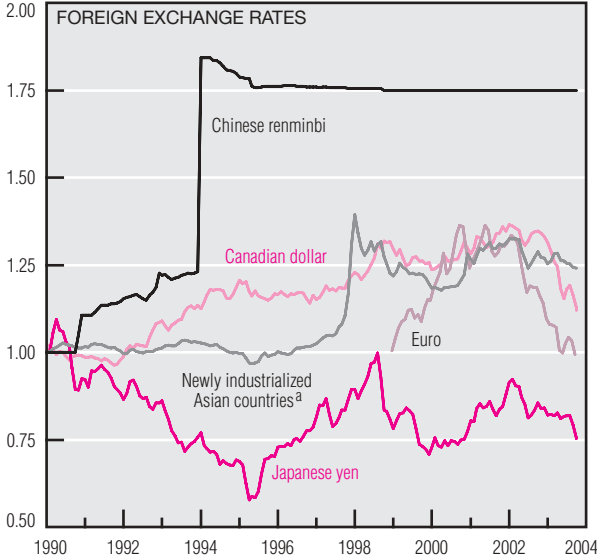
Longer-term interest rates, which have moved little recently, remain well above the lows reached in summer 2003. Conventional mortgages

have followed the 20-year bond closely, although the spread between them has narrowed from 100 bp to 77 bp since August. Likewise, the yield curve has remained quiescent; indeed, it has ended up near the level it reached at the end of 2002. This means, among other things, that the 10-year, three-month spread remains quite high by historical levels—nearly triple its historical average of 120 bp. Although it is sometimes taken as an indicator of future inflation, it is more reliable as a predictor of strong economic growth in the upcoming year.

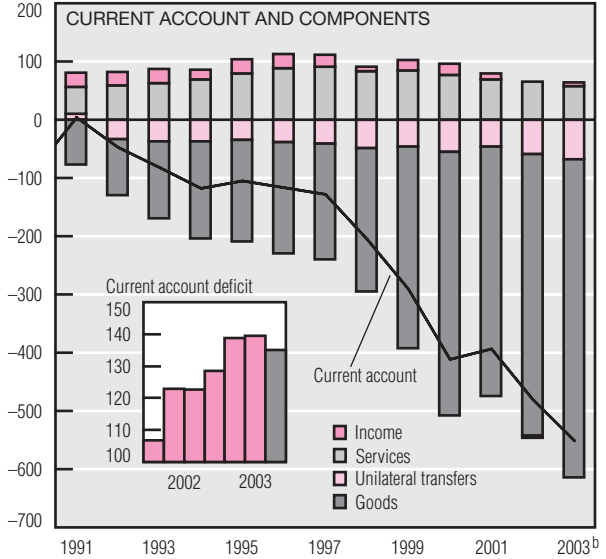
International news has been especially prominent in 2003. By one measure, at least, the effect on the financial markets has not been proportionate. The Treasury-to-Eurodollar (TED) spread looks at the difference between the rate on Eurodollar deposits and Treasury notes. It is thought to pick up traders' worries about international problems because it is a way to arbitrage rates between the U.S. and the rest of the world without bearing any currency risk. The TED spread remains quite low by historical standards.

International Markets

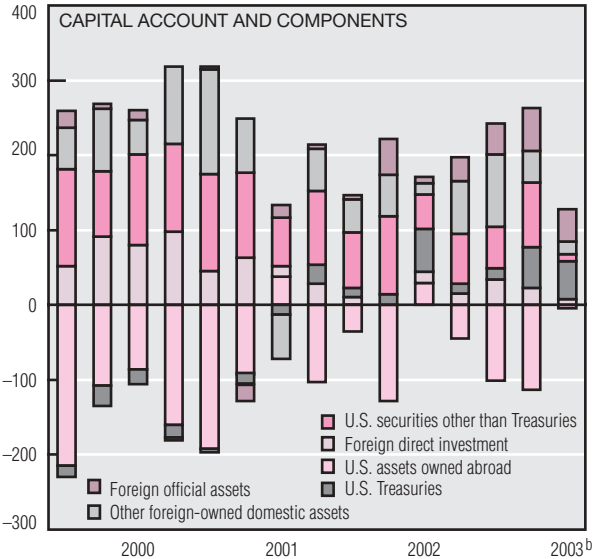
Monthly index, January 1990 = 1



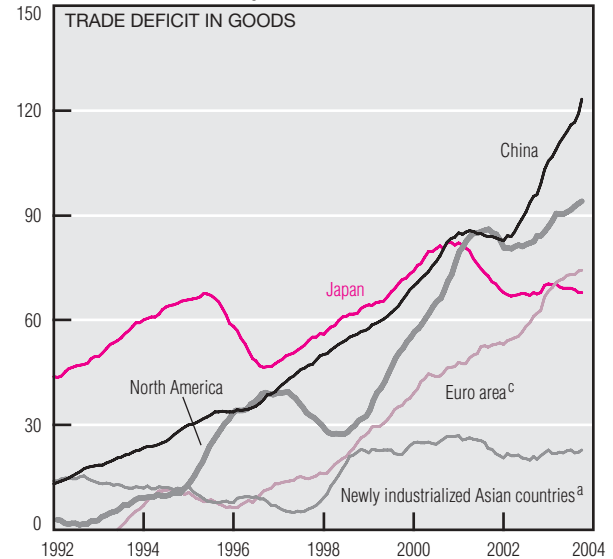
Billions of dollars



Billions of dollars



Billions of dollars, 12 months trailing



a. Hong Kong, Singapore, South Korea, and Taiwan.

b. Through first three quarters, annualized by multiplying by (4/3).

c. Euro area: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census; and Board of Governors of the Federal Reserve System, "Foreign Exchange Rates," *Federal Reserve Statistical Releases*, H.10.

The U.S. dollar continues to decline, particularly against other major currencies. In December, the dollar reached a new low against the euro. Despite this decline, the current account deficit grew for the second straight year in 2003, primarily because of a trade deficit in goods. Many analysts would agree that the current account deficit, as a proportion of GDP, cannot grow indefinitely. Some research has shown that historically, reversal occurs when the current account deficit reaches about 5% of GDP, slightly below where it stands

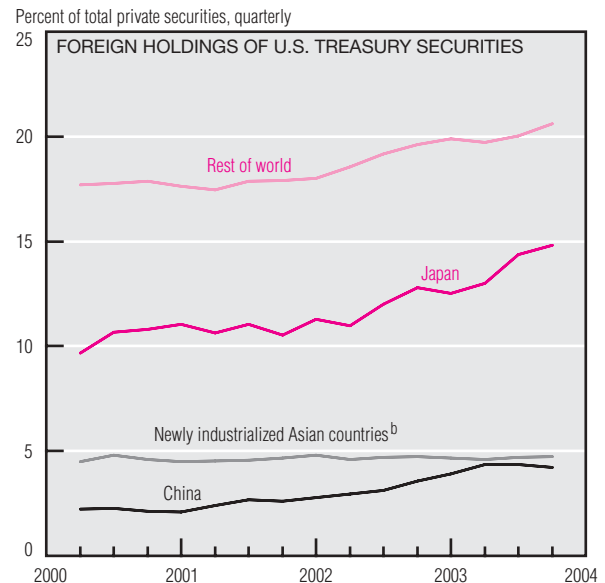
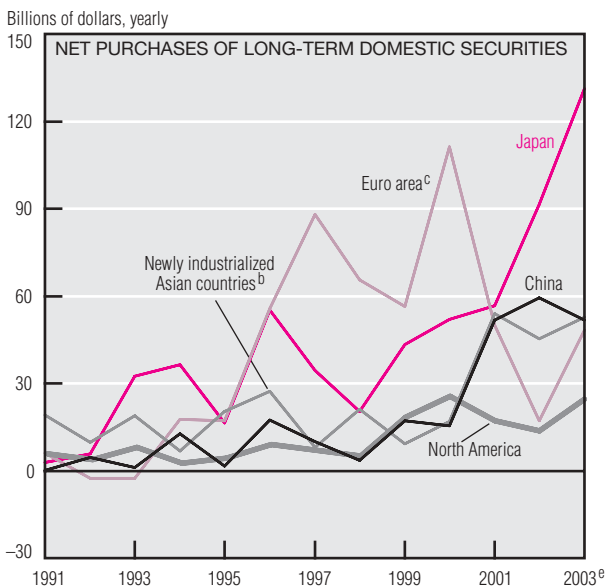
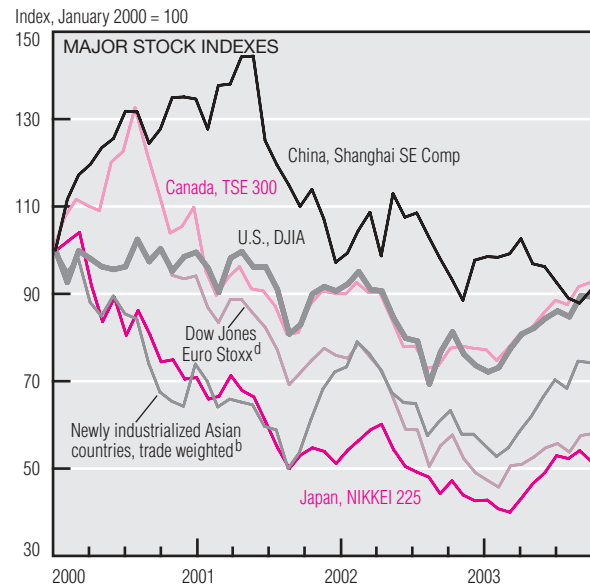
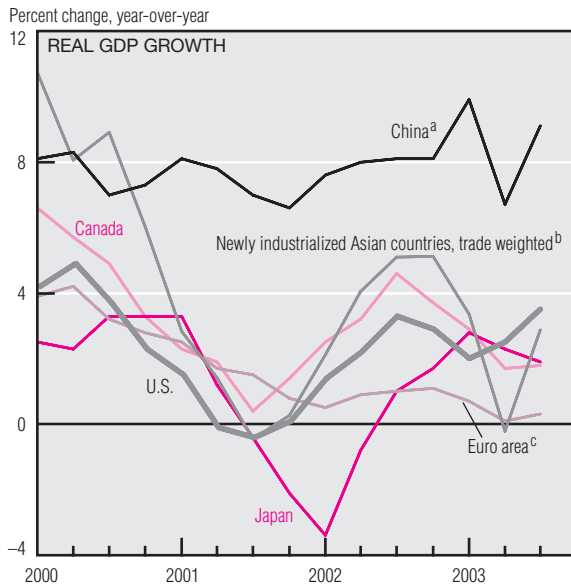
now. In 1986, the deficit reached 3.5% before falling. These may not be good guidelines for the future, however. As Federal Reserve Chairman Greenspan said in a recent speech, "our debt-raising capacity appears to be related to the reduced cost and increasing reach of international financial intermediation."

Saying that the current account deficit cannot rise indefinitely is equivalent to saying that the capital account surplus cannot rise indefinitely, since they are tautologically equal. The surplus in the first two quarters of 2003 was financed by accumulating foreign-

owned assets in the U.S. that exceeded the outflow of U.S.-owned assets abroad. In the third quarter, foreign claims on domestic assets fell, particularly in foreign direct investment and non-Treasury securities. The capital account surplus was virtually unchanged because outflows of U.S. assets owned abroad fell by almost the same amount. In short, foreigners seemed less willing to invest in non-Treasury domestic assets. If this trend continues, either the rate of return on domestic assets must increase, or the capital account surplus must fall.

(continued on next page)

International Markets (cont.)



a. Nominal growth.

b. Hong Kong, Singapore, South Korea, and Taiwan.

c. Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain.

d. August 2000 = 102.51

e. Through October.

SOURCES: U.S. Treasury, Treasury International Capital System, and *Monthly Treasury Bulletin*; and Bloomberg Financial Information Services.

The strong economic growth of the U.S. compared to the rest of the world may be one reason the current account deficit has been able to increase as much as it has. According to U.S. Treasury Secretary John Snow, “when our economy is growing faster than Europe or Japan it means we are capable of buying more goods from them than they are buying from us.” Since the middle of 2001, GDP and stock market growth from the euro area and Japan have, in fact, lagged behind ours. However, while the U.S. trade deficit with the euro area has

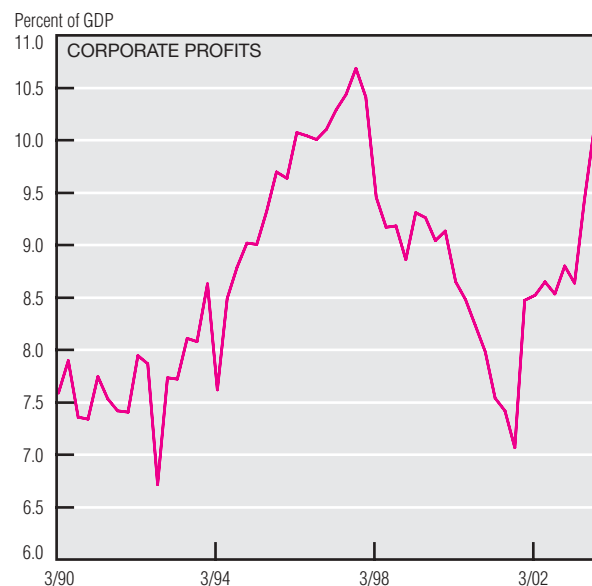
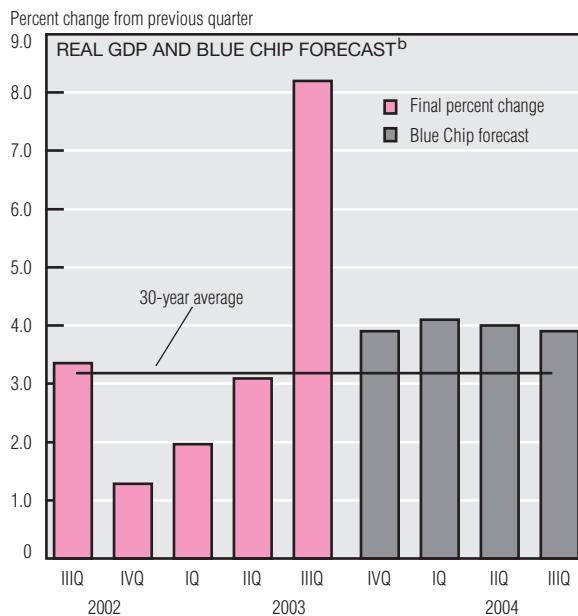
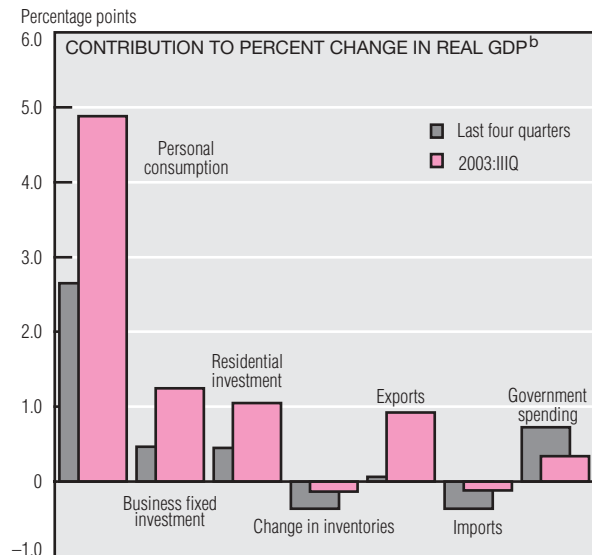
been rising predictably over this period, the trade deficit with Japan has been falling. Furthermore, net purchases of long-term domestic securities from Japan have been rising, whereas those from the euro area have been falling. This illustrates the fact that although the total current account deficit must equal the capital account surplus, the equivalence need not hold on a country-by-country basis.

Although our trade deficit with Japan has fallen—partly because of our increased trade with China—

Japan continues to be the largest purchaser of long-term domestic securities, and its purchases of Treasury securities continue to grow relative to the rest of the world. China’s economy and exports have grown more than those of surrounding countries, but the stock indexes of the newly industrialized Asian countries have significantly outperformed China’s stock market this year—and ours as well, for that matter. China itself runs a large trade deficit with these countries and probably will have a small current account surplus in 2003.

Economic Activity

	Change, billions of 1996 \$	Annualized percent change, last:	
		Quarter	Four quarters
Real GDP	204.8	8.2	3.6
Personal consumption	122.6	6.9	3.7
Durables	64.0	28.0	11.0
Nondurables	37.4	7.3	4.7
Services	28.8	2.8	1.9
Business fixed investment	33.7	12.8	4.6
Equipment	36.1	17.6	6.8
Structures	-1.1	-1.8	-1.9
Residential investment	25.0	21.9	9.2
Government spending	8.3	1.8	3.9
National defense	-1.6	-1.3	12.7
Net exports	20.8	—	—
Exports	24.1	9.9	0.6
Imports	3.2	0.8	2.6
Change in business inventories	4.6	—	—



a. Chain-weighted data in billions of 1996 dollars. Components of real GDP need not add to the total because the total and all components are deflated using independent chain-weighted price indexes.

b. Data are seasonally adjusted and annualized.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and *Blue Chip Economic Indicators*, December 10, 2003.

Even with a benchmark revision, the final real gross domestic product (GDP) for 2003:IIIQ contained no surprises. Real GDP surged ahead 8.2%, the same as in the last estimate. The only changes worth mentioning are that final sales were revised up slightly and inventory investment was revised down.

Real personal consumption accounted for 4.9 percentage points of the total increase in real GDP, far above the average increase of 2.6 percentage points over the last four quarters.

Business fixed investment was the next-largest contributor, adding another 1.25 percentage points. The only negatives were inventories and imports, each subtracting about 0.1 percentage point, but this was far less than the 0.4 percentage point drag that each exerted over the last four quarters.

Although Blue Chip forecasters do not expect the third quarter's out-sized real GDP growth to continue, they do predict that real growth will average nearly 4% over the next four

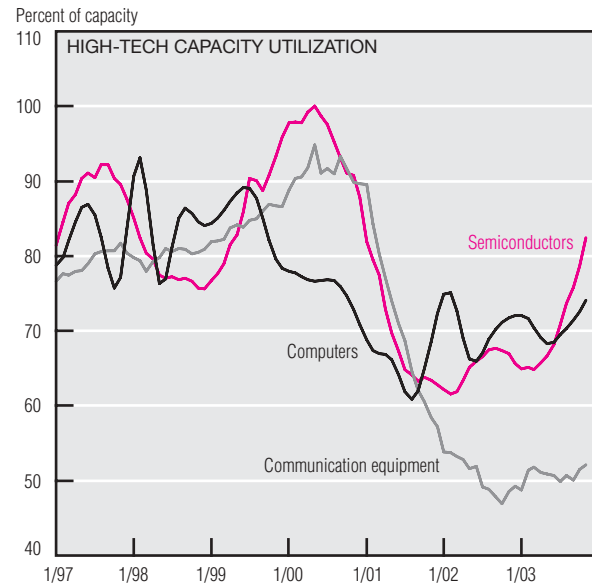
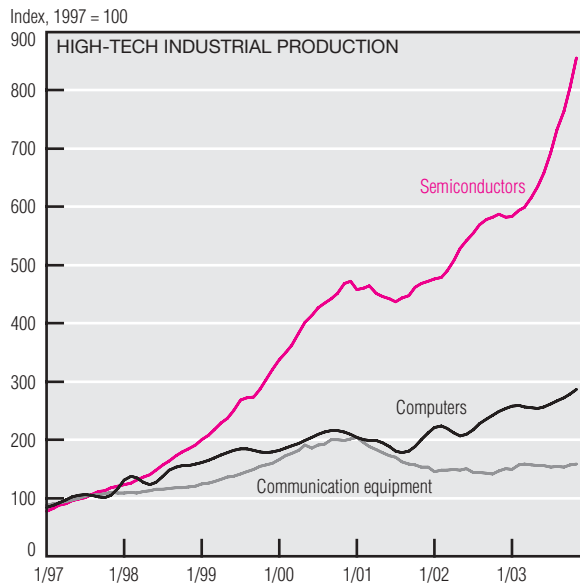
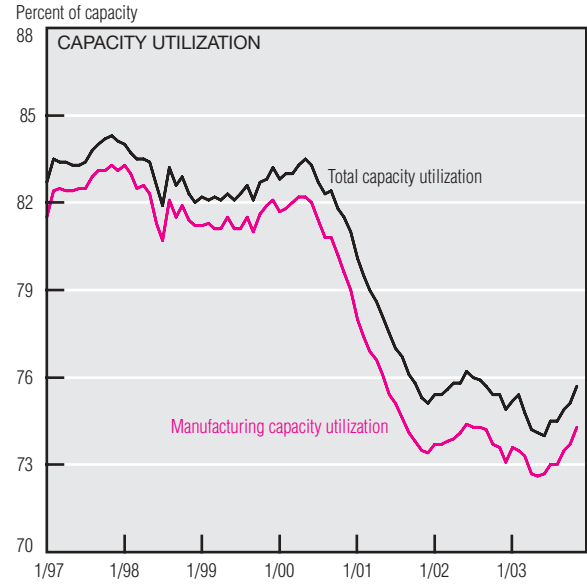
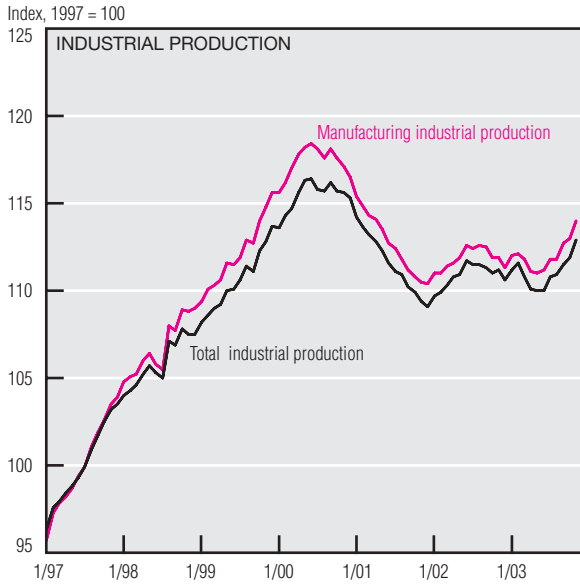
quarters. This is well above the 3.2% average growth of the last 30 years.

Investors will be very pleased with corporate profits' strong rebound. As a percent of GDP, corporate profits are at the highest level since 1997:IIIQ. Pretax earnings adjusted for inventory earnings and depreciation rose 9.9% in the third quarter of 2003, after pushing forward 10.3% in the second quarter.

Strong GDP growth in the second half of 2003 has boosted industrial

(continued on next page)

Economic Activity (cont.)



SOURCE: Board of Governors of the Federal Reserve System.

production and manufacturing production to their highest levels since March 2001, yet they remain about 3% below their respective June 2000 peaks. Mirroring this improvement in production, their rates of capacity utilization have also rebounded from the most recent lows. After falling as far as 74.0% for industrial production and 72.6% for manufacturing late last spring, in November they recovered to 75.7% and 74.3%, respectively. Nonetheless, they remain far below

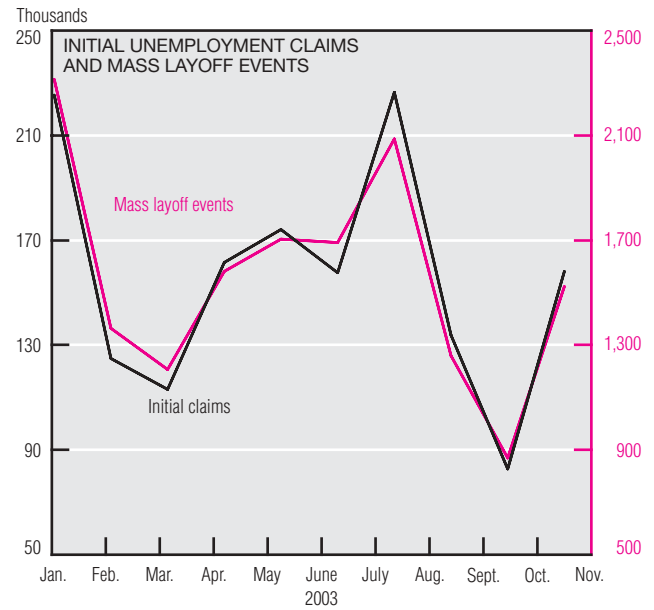
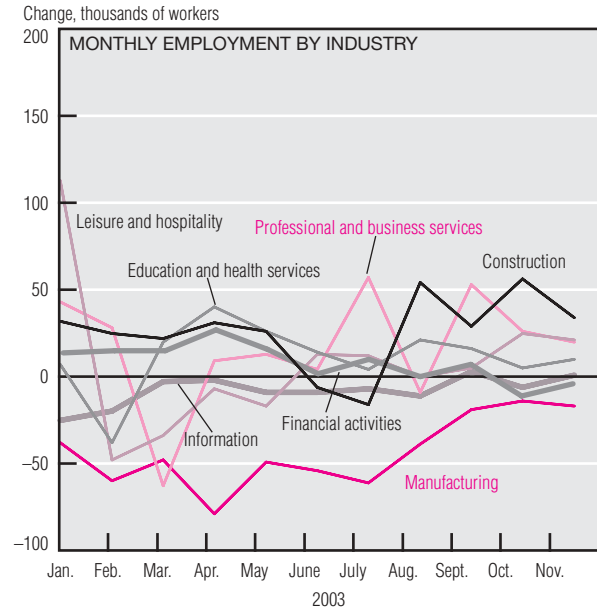
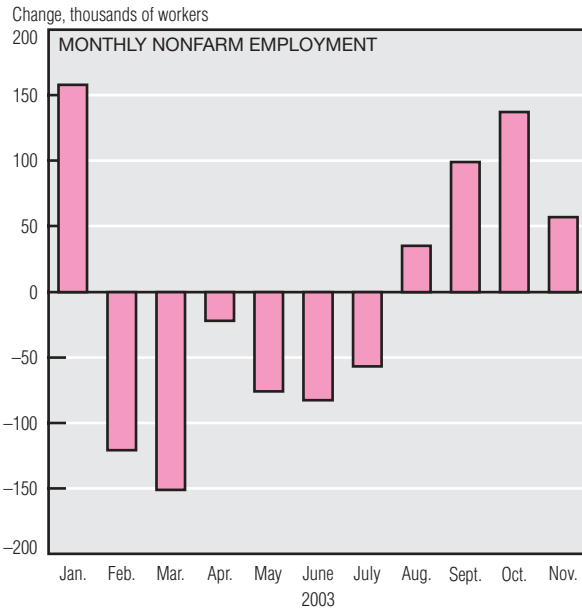
the roughly 80% they tended toward in the late 1990s.

Performance for some high-tech industries has been a bit brighter. Semiconductor production is up more than 150% from January 2000. Although its capacity utilization is down from the remarkable 100% achieved in May 2000, the current 82.4% is much more sustainable, close to the 83.3% it averaged in the 1990s. Production of computers and peripheral equipment is up a still-impressive 57%, although its capacity

utilization of 74.4% is significantly below its 1990s average of 79.4%

Communication equipment manufacturers have recovered somewhat from the aftereffects of their boom around the turn of the millennium, but have not yet recovered fully. Production in this sector is still down about 5% from its January 2000 level, and capacity utilization remains at only 52.1%, which is higher than its 46.9% nadir but far lower than its 1990s average of 81.4%.

Employment Trends



NOTE: All data are seasonally adjusted unless otherwise noted.

The labor market's 2003 performance was mixed, with disappointing numbers for the first half of the year and significant improvement in the final four months. From the beginning to the middle of the year, total nonfarm employment posted net losses; after August, payroll employment increased by 328,000 jobs. Employment trends across industries such as professional and business services, education and health services, and construction have strengthened in 2003. In recent

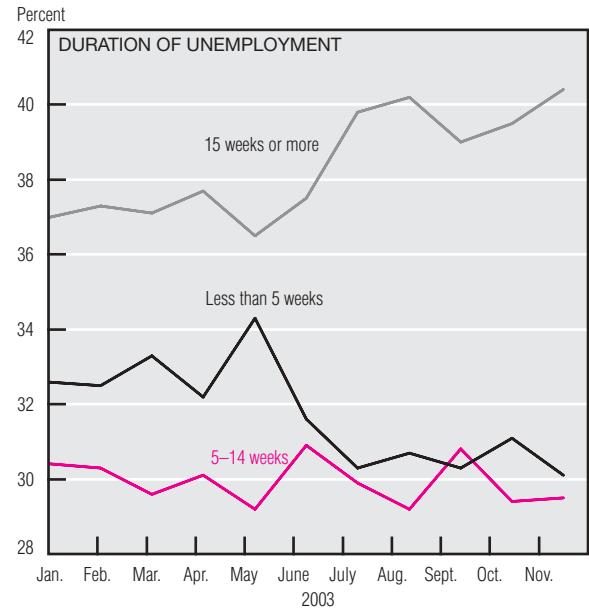
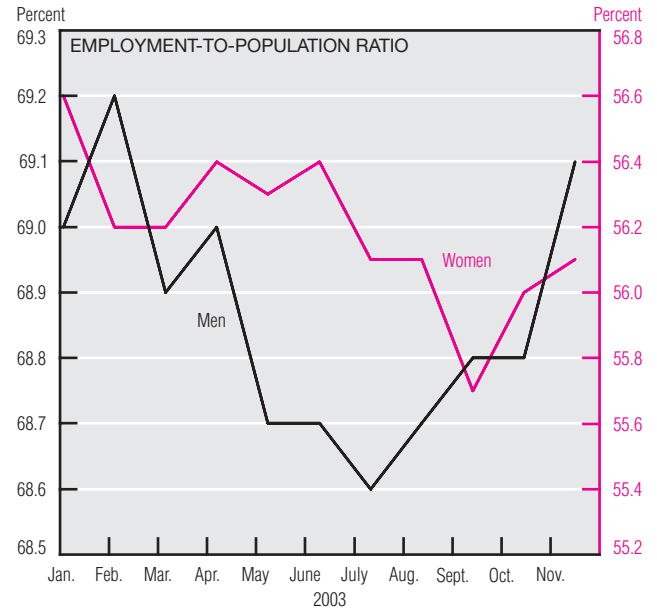
months, job gains have been increasingly broad based. By November 2003 (the latest available data), the share of industries that reported a net increase in employment was at its high for the year. Since 2001, the long-suffering manufacturing industry has posted a net loss of 2.5 million jobs; in recent months, that number has begun to decline.

The diffusion index of employment shows whether establishments' payroll has increased, decreased, or stayed

the same. An index score of 50 means that the number of establishments where employment increased equaled the number where it decreased. The diffusion index' one-month span for total private employment approached 50 in September for the first time in 2003, then continued to rise, reaching 54.7 in November. The manufacturing sector's index varied between 19 and 42 in 2003 until hitting 42.3 in November. Over the course of the year, the numbers of

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Employment Trends (cont.)



NOTE: All data are seasonally adjusted, unless otherwise noted.

a. Not seasonally adjusted.

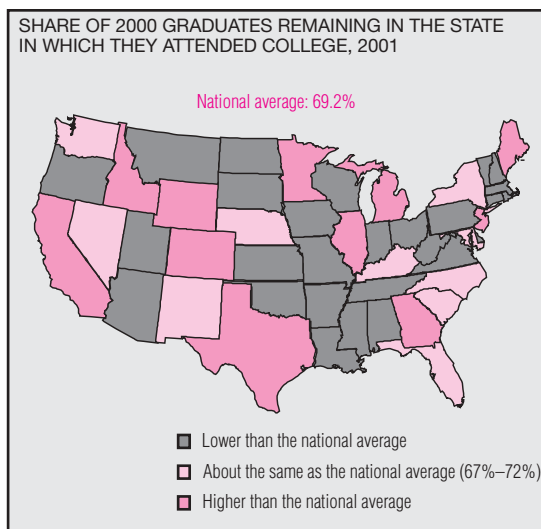
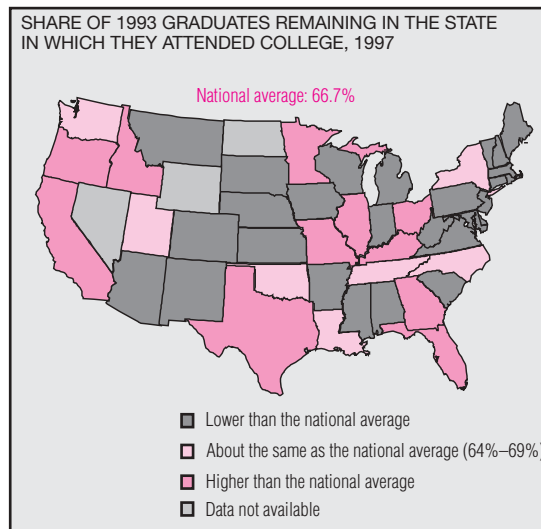
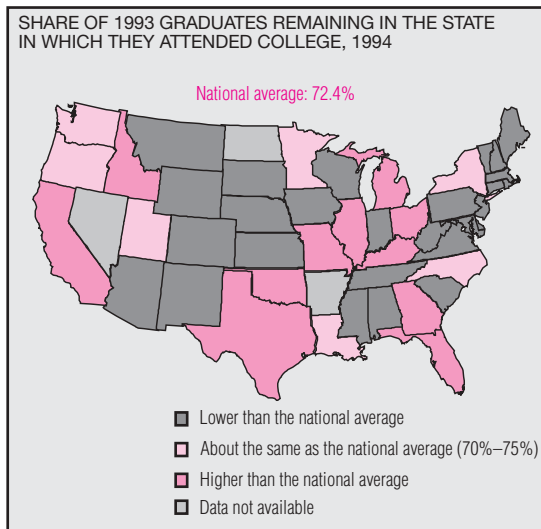
layoff events and initial unemployment insurance claims declined. Although they trended upward again in recent months, they remained below the levels recorded at the beginning of 2003.

In January 2003, the share of men holding more than one job increased, then decreased, until the year-end figure was close to January's. From February to April, the corresponding figure for women declined precipitously but it regained its share over

the course of the year. The employment-to-population ratio for men fell in the first few months of 2003 and then rose to 69.1 by November. For women, it fell over the course of the year. The overall unemployment rate varied between 5.7% and 6.4%, reaching 5.9% in November. The jobless rate for all groups rose in the first half of 2003. Although it trended downward in the second half of the year (except for teenagers), it was nonetheless higher in November than in January

2003. The share of those unemployed for a short duration (less than five weeks) and those with a medium duration (five to 14 weeks) fell over the past year, but the share of those unemployed for a longer duration (15 weeks or more) rose significantly. At the beginning of 2003, 37% were unemployed for 15 weeks or more; by year's end that number had risen to 41%; for those unemployed less than five weeks, the share fell from 32.6% to 30.1% over the same period.

Migration of College Graduates



Highest and Lowest State Retention Rates for 2000 Graduates, 2001

Highest shares (percent)

Idaho (97.4)
 Maine (91.7)
 Texas (86.7)
 California (84.4)
 New Jersey (83.1)

Lowest shares (percent)

Iowa (42.2)
 North Dakota (38.4)
 Rhode Island (37.6)
 Vermont (30.6)
 Delaware (30.2)

NOTE: Data not available for Alaska and Hawaii.

SOURCE: U.S. Department of Education, National Center for Education Statistics.

The U.S. Department of Education conducts a Baccalaureate and Beyond survey that tracks the location, employment, and family patterns of college graduates. So far, this longitudinal study has looked at students who obtained their degrees in 1993 and those who obtained their degrees in 2000. The first study surveyed students in April 1993, when they graduated, and again in April 1994 and April 1997. The 2000 class was surveyed in April 2000 and April 2001 and will be surveyed again in April 2004. The survey provides a unique opportunity to

track college graduates as they move from state to state.

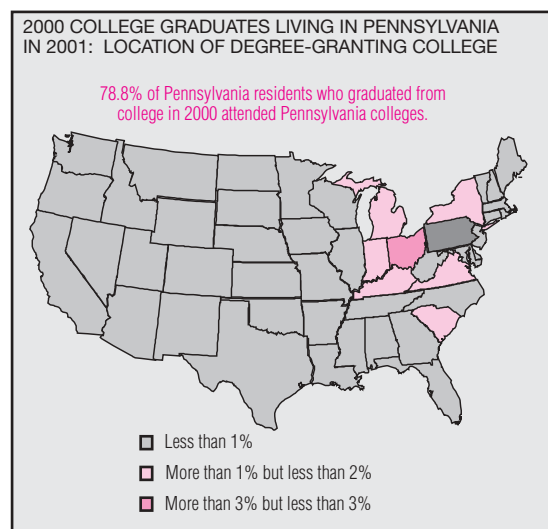
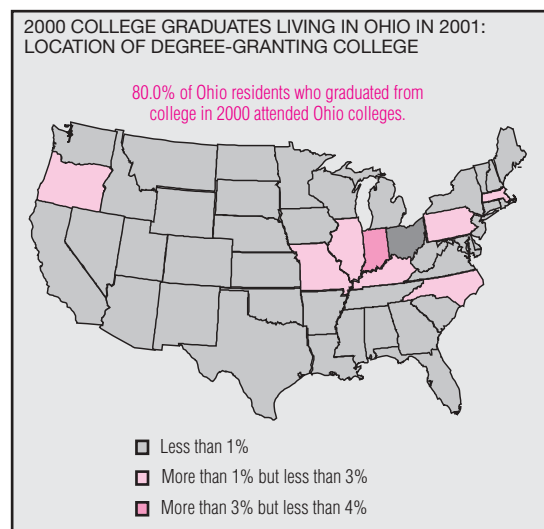
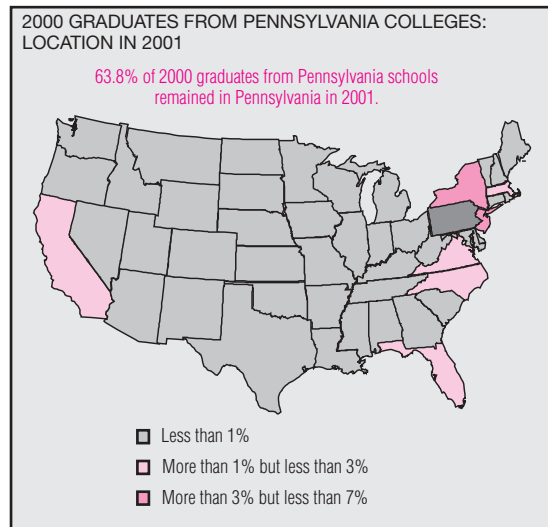
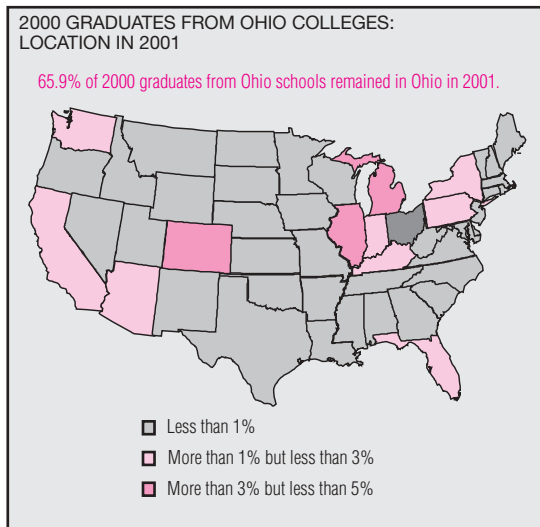
Among 1993 graduates, 72.4% were still in the state where their degree-granting college was located one year after graduation (1994), and 66.7% were still in the same state as their degree-granting institution four years after graduation (1997). Retention rates in the Fourth District states of Ohio and Kentucky exceeded the national average in both 1994 and 1997: More than $\frac{3}{4}$ of Ohio graduates still lived in the state in 1994, and just over 73% still lived there in 1997. Kentucky's retention rate rose during

the survey period: In 1994, 80.9% of Kentucky graduates lived in the state; by 1997, that figure had risen to 83.3%, the highest retention rate of any state for which data were available in the 1997 survey.

Respondents in the survey of 2000 graduates seemed more willing to move, within a year of graduation, from the state in which they attended college: In 2001, 69.2% of 2000 grads nationwide were still in the state where their school was located. Although Ohio's retention rate of 65.1% was below the national mean, it

(continued on next page)

Migration of College Graduates (cont.)



NOTE: Data not available for Alaska and Hawaii.
SOURCE: U.S. Department of Education, National Center for Education Statistics.

was well within the average range: The middle 25 states had retention rates between 60% and 71%. The Fourth District states of Kentucky, Pennsylvania, and West Virginia were also among the middle 25, with retention rates of 69.0%, 63.4%, and 61.6%, respectively. Five states were able to keep more than four out of every five (80%) graduates they produced in 2000; five others could not keep even half.

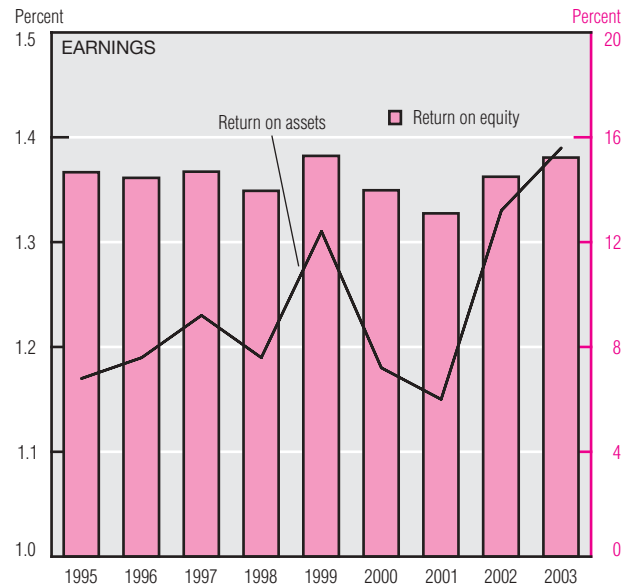
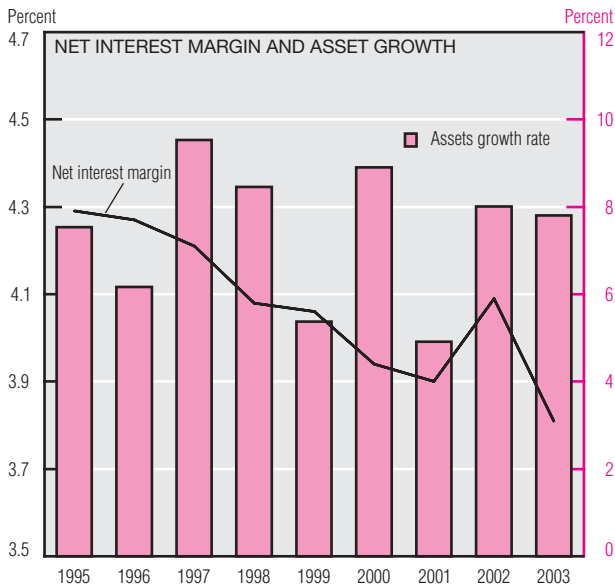
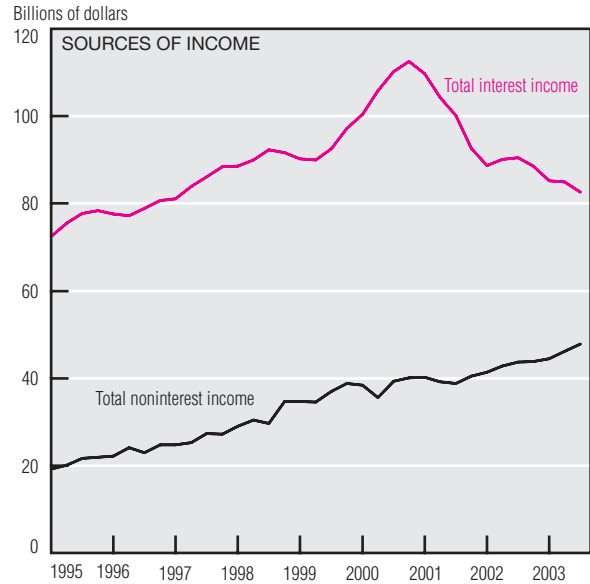
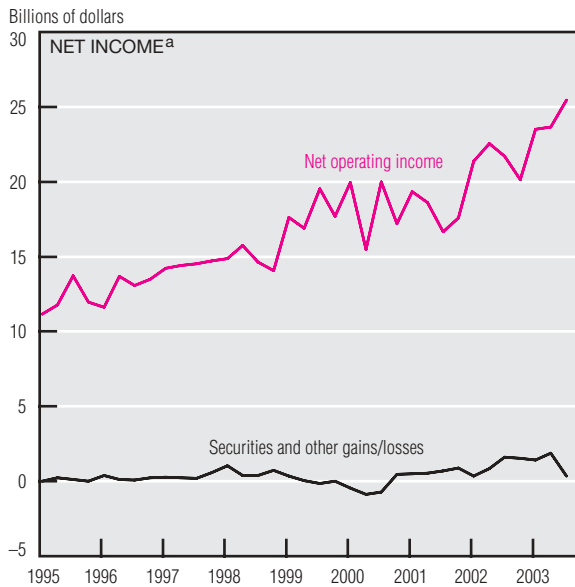
In studying the 2001 data, it is important to remember that economic factors unique to the recession may have affected retention rates. Both

Ohio and Pennsylvania were net exporters of education in 2001, with Ohio exporting a net of roughly 9,000 graduates, and Pennsylvania exporting about 12,000. A major cause of this phenomenon was undoubtedly the region's struggling labor markets. A number of critical industries in both states underwent significant job reductions both before and during the recession.

Of students leaving Ohio and Pennsylvania on graduation, a significant number move to California, Florida, and New York. Apart from migrants to those populous states, most graduates

tend to move within the region: Ohio grads tend to stay in the Great Lakes region, while Pennsylvania grads who move out of state tend to favor the East Coast. Just as some of the students educated in Ohio and Pennsylvania elect to move out of those states when they graduate, some students graduating from schools in other states choose to move into Ohio and Pennsylvania. In Ohio, the largest share of immigrating college grads come from Indiana schools, while the largest share of those migrating to Pennsylvania are from Ohio schools.

FDIC-Insured Commercial Banks



a. Net income equals net operating income plus securities and other gains and losses.
 SOURCES: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

In 2003:IIIQ, FDIC-insured commercial banks' net operating income improved on the previous quarter and recovered strongly from its dip in 2002:IVQ. Compared to a year earlier, it was up 17.4%. Net income, the sum of net operating income and securities gains and losses, was also up, gaining 10.6% relative to a year earlier. The increase in earnings was kept in check by reduced gains on the sales of securities and other assets.

Commercial banks' total interest income, at \$83 billion, declined slightly from the previous quarter. Because of falling interest rates, it was significantly

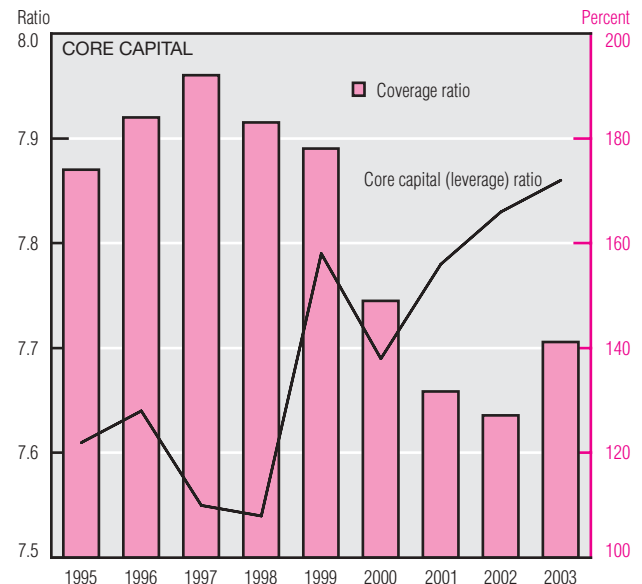
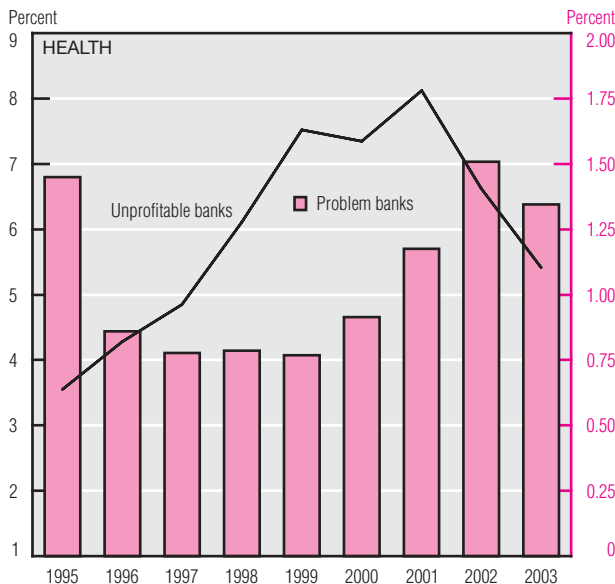
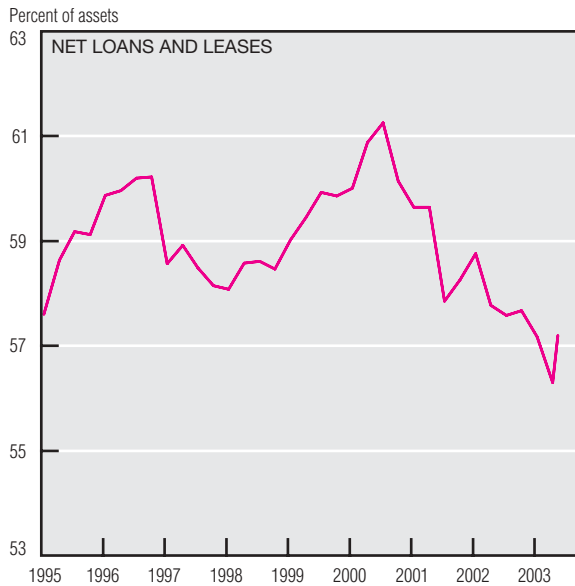
less than the \$113 billion achieved in 2000:IVQ. Total noninterest income continued to rise, reaching a level 9.3% higher than a year earlier, another sign that the earnings pressures affecting banks during the recession of 2001 are abating.

The improvement in overall earnings occurred despite the narrowing net interest margin (interest plus dividends earned on interest-bearing assets minus interest paid to depositors and creditors, expressed as a percentage of average earning assets). It declined from 4.09% in 2002 to 3.81% in 2003:IIIQ.

Although low interest rates are one cause of shrinking margins, another reason, just as important, is strong asset growth. Assets of FDIC-insured commercial banks grew 7.8% (annualized) in 2003:IIIQ. Yet, even with near-record asset growth, depository institutions' return on assets reached almost 1.4%, the highest since 1989. Return on equity, at 15.2%, was at its post-1999 peak.

Although net loans and leases as a share of total assets increased slightly to 57.2% in 2003:IIIQ compared to the previous quarter, it was still down
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FDIC-Insured Commercial Banks (cont.)



SOURCES: Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, various issues.

from a year earlier. Net loans and leases grew 7.1%, but total assets grew 7.8%, causing the year-over-year ratio to decrease slightly. Although the ratio was well below its recent high of 61.3% in 2000:IIIQ, lending was brisk during the first three quarters of 2003, partly because of the refinancing activity that resulted from low interest rates in the lending market.

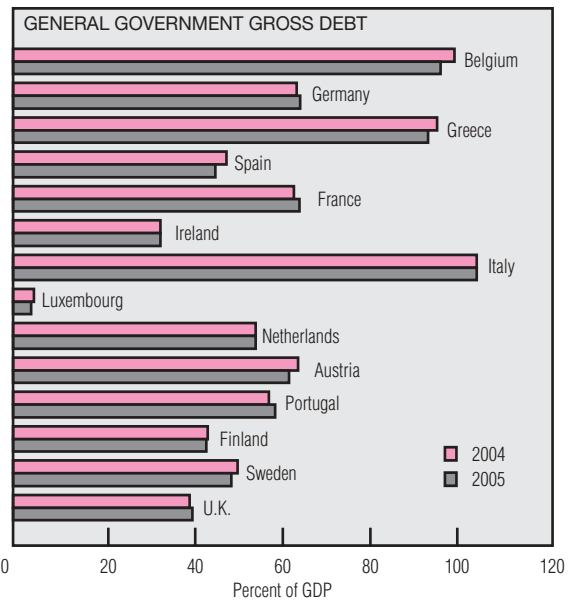
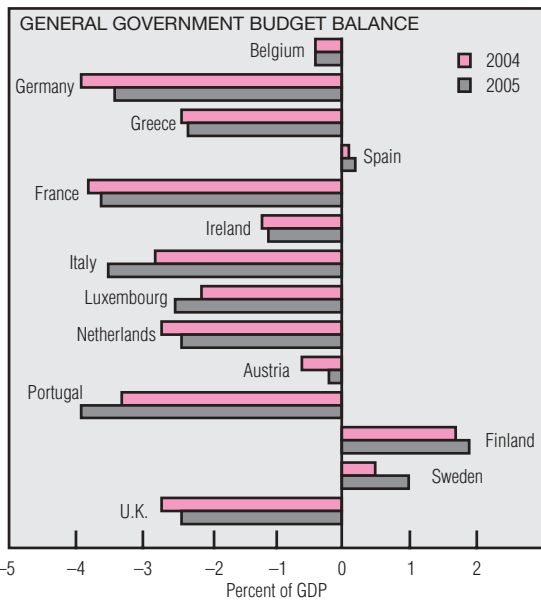
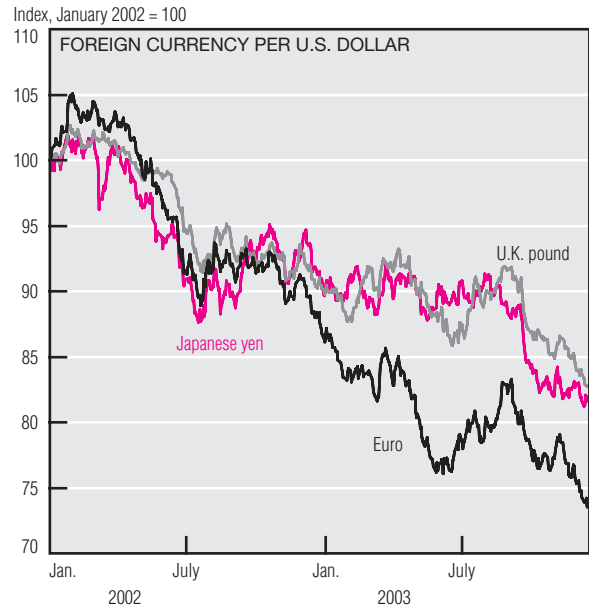
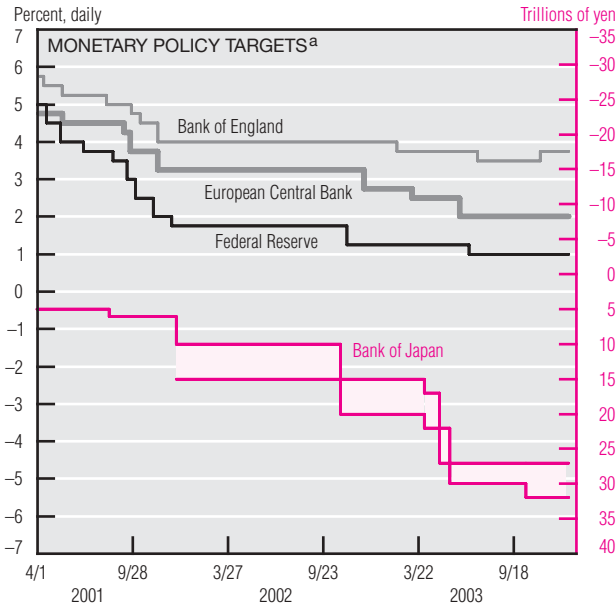
Asset quality showed signs of improvement in the third quarter. Net charge-offs (loans and leases removed from balance sheets because of uncollectibility minus recoveries)

fell for the first time since 1999, reaching 0.9% of total loans. Problem assets (nonperforming loans and repossessed real estate) as a share of loans and leases fell to 0.40% from 0.53% at the end of 2002. The improvement in asset quality was caused by the lower debt-servicing costs that resulted from refinancing at lower interest rates, combined with aggressive tightening of lending standards.

FDIC-insured commercial banks' improvement in asset quality was also reflected in the decline of unprofitable

institutions' share to 5.4%. Problem banks (those with substandard exam ratings) as a proportion of total banks also fell to 1.34%. The coverage ratio (prudential reserves as a share of noncurrent loans and leases) rose to 141% in 2003:IIIQ from 127% at the end of 2002, the first increase since 1997. Core capital, which protects commercial banks against unexpected losses, increased slightly to 7.86%. All of these performance indicators show that the banking sector is strengthening.

Foreign Central Banks



a. Federal Reserve: overnight interbank rate. Bank of Japan: a quantity of current account balances (since December 19, 2001, a range of quantity of current account balances). Bank of England and European Central Bank: two-week repo rate.
 SOURCES: Board of Governors of the Federal Reserve System; Bank of Japan; European Central Bank; Bank of England; People's Bank of China; Wholesale Markets Brokers Association; and European Commission, *Economic Forecasts*, Autumn 2003.

The four major central banks left their policy targets unchanged as the British pound, the euro, and the yen continued to appreciate relative to the U.S. dollar. While the Bank of England held its repo rate at 3.75%, one member of its Monetary Policy Committee voted against the decision, preferring a 4% rate. Also, consistent with last June's announcement and with practice elsewhere in the European Union, the Chancellor of the Exchequer has reset the Bank's inflation target to 2%, reflecting a change to a harmonized

index of consumer prices as the basis for targeting.

According to the Bank of Japan, economic recovery is expected to continue, "albeit at a moderate pace," and consumer prices are "basically projected to continue falling slightly." Likewise, the European Central Bank "noted that the economic recovery in the euro area has started and that confidence has strengthened further"; that annual inflation rates are likely to fluctuate around 2% over the coming months; and "that a gradual

and limited decline should take place later on."

In a somewhat controversial decision, the European Council held in abeyance the Excessive Deficit Procedures that the European Commission recommended imposing on France and Germany. The Commission's autumn forecasts projected that the two nations' government deficits and debt would remain above the Growth and Stability Pact ceilings of 3% and 60% of GDP, respectively, through 2005.

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